LESSONS FROM THE ASIAN CRISIS

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The Asian crisis is not yet over, although there are important signs of progress to which I will return shortly. While we should start thinking about the "lessons" to draw from the Asian experience, firm conclusions would be premature. There will be debate for years to come, and controversies will linger. For the time being, let me highlight a number of lessons that have already been drawn in a rush to judgment by some in the academic world and the financial press. I will finish with a few preliminary conclusions of my own.

One recent judgment by *The Economist*--which is cosponsoring today's conference--is that "by any normal standards" the IMF's intervention in Asia has not worked *(October 10, 1998).* Obviously, I do not agree with this judgement, and I will return to this issue a little later in my presentation. Meanwhile, it raises, of course, the question, "What alternative interventions would have worked?" While *The Economist* did not go into this, there is no lack of alternative proposals, some of which are mutually contradictory. According to their proponents, each proposal would have provided the real solution to deal with the Asian crisis. Let me go through some of these, one by one:

Interest-Rate/Exchange-Rate Tradeoffs

Alternative interest rate/exchange rate tradeoffs have been proposed:

- One widely discussed proposal has been that countries should have restored confidence at the onset of the crisis by lowering interest rates and accepting a greater exchange rate depreciation. This proposed trade-off neglects the reality that currencies had already overshot at the start of the crisis. The authorities, being aware of the existence of substantial unhedged foreign currency debts, were concerned that the damage that would result from a steeper slide in the value of the domestic currency would be greater than that from temporarily higher interest rates. Instead, the strategy was to raise short-term money market interest rates to stabilize the foreign exchange market, and to reduce them as soon as confidence returned and currencies started to strengthen. Short-term interest rates in Korea and Thailand are now below pre-crisis levels and, in Indonesia, they have started on a downward trend.

- An opposite proposal from that put forward by the low interest rate proponents was to peg the exchange rate, and to defend it using high interest rates and intervention. This option was really not open to Thailand and Korea which had lost virtually all their reserves at the onset of the crisis, nor to Indonesia whose reserves were dwindling fast.

- Both of the extreme solutions on exchange rate policy were avoided by allowing a depreciation, but limiting its extent by an initial tightening of interest rate policy as well as by the mobilization of very considerable official inflows. (Disbursements under the programs were heavily front-loaded.)

Capital Controls

The proposal to introduce capital controls and, thereby, allow a quick reflation of the economy, was implemented only recently by Malaysia. We will, thus, have the opportunity to assess the efficacy of this option. However, I should point out that other countries, now at the stage of doing everything possible to revive private capital inflows, partly to help recapitalize banks, have come out strongly against such a proposal.

External-Debt Management

Some have proposed that countries should have defaulted at the outset, giving a "lesson" to reckless creditors. This proposal is often combined with the idea that no official financing to crisis countries should have been provided in order to avoid "moral hazard." This option was not taken up by any of the Asian countries. They are well aware that punishing creditors in a unilateral and preemptory way also means inflicting greater damage to themselves, as the disruption of orderly financial relationships would make recovery of their open economies doubly difficult. Instead, they chose to enter into negotiations with creditors to restructure their debt, with the IMF playing a supportive role in this process.

Fiscal Policy

Together with lower interest rates, it has also been proposed that fiscal policy should have been expansionary at the start of the program. In hindsight, this proposal has some merit. However, at the onset of the crisis, before anyone could have predicted the extent of the regional recession--especially in Japan--the programs incorporated modest tightening of fiscal positions. This was in order to make room for the future interest costs of financial restructuring and--depending on the external current account situation--to reduce the burden on the private sector in bringing about external adjustment. (In practice, the fiscal tightening sought was significant only in Thailand where, nevertheless, the fiscal position remained in deficit during 1997.) However, as the depth of the recession became evident, the programs were adjusted to generate a fiscal stimulus. Thus, everywhere, the fiscal stance is now expansionary, going beyond the automatic fiscal easing associated with the change in economic conditions. (In practice, the switch in the fiscal position has been slow to materialize.)

I should stop at this point in reviewing alternative proposals. The bottom line is that countries avoided extreme remedies and, in so doing, they have been vindicated on many counts

by the results achieved thus far. You are all, I am sure, well aware of the progress that has been made by the Asian countries, which may be summarized briefly as follows:

- In each of the crisis countries—even in Indonesia—exchange rates have strengthened very significantly. Korea and Thailand have now accumulated an impressive track record of exchange rate stability.

- There has been a very substantial strengthening of external reserves, whose depletion, marked the onset of the crisis. Thailand's net international reserves, barely positive just over 12 months ago, have risen to around $16 billion, and gross reserves are about $28 billion--more than 150 percent of Thailand's short-term debt. Korea's gross international reserves have risen from only $7 billion at the end of last year, to more than $40 billion. Indonesia's reserves have also risen to about $20 billion.

- These achievements have been underpinned by very sharp turnarounds in the current account, with surpluses in the range of 10–12 percent of GDP expected for Korea and Thailand this year. While import compression continues to be the main explanatory factor, and export dollar values remain weak, closer scrutiny reveals welcome and significant export volume responses (including from Indonesia) to Western markets.

- By and large, the Asian countries have avoided the inflationary spirals that often accompany large depreciations.

- Short-term money market interest rates have declined, sharply and relatively quickly in Korea and Thailand to pre-crisis levels. The process has started in Indonesia as well.

These are considerable achievements, marking decisive progress in dealing with the immediate foreign exchange crisis. Of course, it is a matter of considerable concern that broader economic recovery is not yet at hand. Remember, though, that four quarters into Mexico's crisis growth continued to be sharply negative, despite the benefits of a benign international environment and a strong U.S. economy; also, that the average American recession last about a year. Growth in the Asian countries could resume next year, though much depends on the external environment. Let me now present some lessons I would personally draw:

Bank Restructuring

The major element underlying the Asian crisis is the weakness of the financial sector. These problems accumulated over the years as a result of political interference in lending decisions and lax banking supervision, and came to the surface after the collapse of the real estate boom. The programs in each country put bank restructuring as their centerpiece because without restoring the viability of the banks, credit flows will not resume--even if interest rates are pushed to zero--and a durable recovery will not get off the ground. It is astonishing that many critics

draw the opposite conclusion, contending that structural polices--in addition to needed macroeconomic stabilization policies--overload the implementation of capacity of governments and undermine political stability.

My own conclusions on this issue are twofold: first, before the crisis, country authorities should have done more, not less, in dismantling governance systems that shielded financial institutions and corporations from market discipline. Instead, a policy environment was perpetuated that encouraged loan leverage and liberalized short-term financial flows--in contrast to standard advice on sequencing financial sector liberalization--while neglecting prudential oversight and preserving nontransparent ties between the government, the business sector, and financial institutions. This system was increasingly vulnerable to crisis. Although many of the weaknesses that have been exposed with the crisis had been identified in advance by the IMF, in hindsight, we did not press hard enough to get countries to take remedial action. Second, after the crisis broke, failure to tackle these issues as part of the policy response would have been devastating to domestic and foreign confidence, and would not have produced the basis for durable recovery. Indeed, each time markets perceived reluctance on the part of governments to restructure financial and corporate institutions, reaction was swift and severe. Countries have accepted the need for restructuring, and their efforts have reached a critical stage. Further progress over the coming months will greatly determine the timing and strength of economic recovery. Once viability is restored to the banking system it has to be maintained through a strong and politically independent regulatory and supervisory system, such as those now being put in place in all countries.

Foreign Borrowing

The rapid accumulation of short-term foreign debt by banks and private corporations was an important trigger of the crisis. When creditors' assessment of country risk changed from optimism to pessimism, these credits were suddenly withdrawn in panic. The lesson I personally draw is that short-term capital movements should be better monitored and excessive inflows prevented through prudential monitoring; in some cases, tax disincentives may help, but the conditions for their efficient use are demanding. (Careful sequencing of capital account liberalization in Thailand and Korea--which means starting at the long end, and moving to the short end only as financial systems are strengthened--could also have helped dampen the volatility of capital flows.) It bears recalling that, while domestic borrowers were at fault, so also were private lenders which, attracted by high returns in Asia, failed to consider more carefully the environment into which they were lending.

Private Lenders

Crisis countries would have moved more quickly to stabilization and recovery, if there had been greater certainty that private creditors would roll over debts, restructure these debts, or provide new money, rather than fleeing progressively from emerging markets, depriving countries of needed liquidity. The conclusion is that private lenders should be involved at an early stage, but there are no easy answers to the question of how to "bail-in" private creditors in resolving financial crises while achieving equitable burden-sharing vis-à-vis the official sector and limiting moral hazard. Work on these important issues is in progress.

Social Safety Nets

In the countries hit by the crises, adequate safety nets were not in place when they were needed, and had to be painstakingly put in place in an ad hoc manner. In Indonesia, social protection had to rely mainly on expanding subsidies, which predictably turned out to be not the most efficient way to achieve this goal. I draw the lesson that these countries should systematically build a system of social protection and rely less on the traditional family support system which, in any case, cannot be relied upon indefinitely. In this effort, countries can learn from the experience of advanced countries and avoid some of the mistakes they have made.